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# In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 1162

DANICA ENTERPRISES, INC., PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. B 19a–27a) are not officially reported; they appear at 26 CCH T.C. Mem. 816. The opinion of the court of appeals (Pet. App. B 5a–18a) is reported at 405 F. 2d 673.

### JURISDICTION

The judgment of the court of appeals was entered on December 17, 1968, and a timely petition for rehearing was denied on January 7, 1969 (Pet. App. B 28a–30a). By order entered on March 7, 1969, Mr. Justice Harlan extended the time to file a petition

for a writ of certiorari to and including April 15, 1969. The petition was filed on March 15, 1969.

## QUESTION PRESENTED

Whether a corporation formed for the purpose of avoiding the application to its sole shareholder of Section 270 of the Internal Revenue Code, which denies to individuals business loss deductions in excess of $50,000 incurred in each of five consecutive years, is barred by Section 269 of the Code from taking loss deductions in excess of $50,000 which would have been denied to the sole shareholder had the business not been transferred to the corporation?

## STATUTE INVOLVED

The relevant portion of Section 269 of the Internal Revenue Code of 1954 is set forth in the appendix, *infra*, p. 13.

## STATEMENT

Petitioner is the wholly-owned corporation of Victor Borge, the entertainer. In 1952, Borge, who enjoyed a large income from his entertainment activities, began operating a poultry business known as "ViBo Farms." From 1952 to 1957 the poultry business sustained substantial losses. On Borge's individual tax returns for those years the losses were deducted from the income of his entertainment activities. (Pet. App. 20a–21a.)

During the four year period 1954 through 1957 the losses exceeded $50,000 annually. For the first two months of 1958, there was a loss of $23,133. In February 1958, Borge incorporated petitioner. In exchange for all the stock, he transferred to petitioner the assets

of ViBo, subject to existing liabilities (Pet. App. 22a). At the same time Borge and petitioner executed a contract whereby Borge agreed to perform on petitioner's behalf specified entertainment services for five years in return for an annual salary of $50,000 (Pet. App. 23a). Although petitioner realized substantial income from Borge's performance of entertainment services, the losses from the poultry business exceeded this income. During Borge's taxable years of 1958 through 1961 he was not paid the $50,000 salary. He did receive $50,000 in 1962 (Pet. App. 23a). During each of its taxable years 1959 through 1962, petitioner incurred losses in excess of $50,000, and claimed deductions for these losses in computing its taxable income.

For the years 1958 through 1962 the Commissioner allocated $75,000 of income from petitioner to Borge pursuant to Section 482 of the Internal Revenue Code of 1954, which allows the Commissioner to allocate gross income between two or more commonly controlled trades or businesses "in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses." As for petitioner's tax liabilities, the Commissioner disallowed the operating loss deductions attributable to the poultry business in excess of $50,000 per year for taxable years 1959 through 1962. The ground of disallowance was the Commissioner's conclusion that the principal purpose of incorporating the poultry business was to avoid a recomputation of Borge's individual tax liability under Section 270 of the Internal Revenue Code of 1954 (Pet. App. 3a), which requires disallow-

ance of losses incurred in excess of $50,000 per annum incurred for five consecutive years (Pet. App. 1a).

Petitioner and Borge both sought redeterminations of the deficiencies in the Tax Court. That court sustained the Commissioner's determinations (Pet. 25a–27a). The court of appeals affirmed (Pet. 5a–18a), one judge dissenting as to the deficiencies against petitioner (Pet. 16a–18a).

## ARGUMENT

The Tax Court and the Court of Appeals for the Second Circuit have correctly decided this case, and there is no conflict of decisions that may appropriately be resolved on the basis of the instant record.

1. In the language pertinent here, Section 269 of the Internal Revenue Code provides that "[i]f * * * any person or persons acquire * * * control of a corporation * * * and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy," then the deduction or credit is denied. The sweeping language of the statute and its legislative history show that it was intended to have a broad *in terrorem* effect upon the use of the corporate form to avoid or diminish tax consequences that would otherwise be incurred. As the responsible committees of the Congress said in recommending the initial predecessor of Section 269,[1] the statute was "designed to put an end promptly to any

[1] Section 129 of the Internal Revenue Code of 1939.

market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability. * * * [T]he section has not confined itself to a description of any particular methods for carrying out such tax avoidance schemes but has included within its scope these devices in whatever form they may appear." H. Rep. No. 871, 78th Cong., 1st Sess. 49; accord S. Rep. No. 627, 78th Cong., 1st Sess. 59.[2]

The situation here fits clearly within the statutory language. The organization of a corporation constitutes an "acquisition" of control by the shareholders within the meaning of the statutory language quoted above.[3] But for the incorporation of petitioner to carry on the poultry business of Borge, its sole stockholder, losses incurred in excess of $50,000 in 1959 and in succeeding years would have been barred by Section 270. The Tax Court found that (Pet. App. B 25a) "[t]he most persuasive evidence supports the Commissioner's determination" that petitioner should be denied deductions in excess of $50,000 for the years in question and that (*id.* 26a) "the Commissioner had reason to hold that 'the principal purpose for which such acquisition was made' was evasion of Federal

[2] See, also, Treasury Regulations on Income Tax (1954 Code), Sec. 1.269; *Commissioner* v. *British Motor Car Distributors, Ltd.*, 278 F. 2d 392 (C.A. 9); *James Realty Co.* v. *United States*, 280 F. 2d 394 (C.A. 8); and *Coastal Oil Storage* v. *Commissioner*, 242 F. 2d 396 (C.A. 4).

[3] See *Zanesville Investment Co.* v. *Commissioner*, 335 F. 2d 507, 513–514 (C.A. 6); *James Realty Co.* v. *United States*, 280 F. 2d 394 (C.A. 8); *Coastal Oil Storage Co.* v. *Commissioner*, 242 F. 2d 396 (C.A. 4); See, also, Regulations, Section 1.269–3(b)(2).

income tax within the meaning of Section 269(a)(1)". The court of appeals sustained this finding as not clearly erroneous and petitioners have not challenged the finding either in the court of appeals or in this Court. Thus Section 269 has been properly applied here to forestall the tax avoidance objective that attended petitioner's formation.

2. Petitioner argued below, as it does here (Pet. 14–15), that Section 269 may never be used to disallow the deductions of losses occurring after the acquisition of control of a corporation unless those losses are "built in," in the sense that they were economically sustained before acquisition. The majority of the court of appeals rejected this construction of the statute, relying on the statements in the House and Senate reports (Pet. App. 15a–16a) "that 'anticipated' or 'prospective' losses were among those that the Commissioner could disallow as deductions under Section 269. H.R. Rep. No. 871, 78th Cong., 1st Sess. [p. 49] * * *; S. Rep. No. 627, 78th Cong., 1st Sess. [p. 58] * * *." The majority of the court of appeals added (Pet. App. B 16a):

> While there is authority to the contrary (*Herculite Protective Fabrics Corp., v. Commissioner,* 387 F. 2d 475 (3d Cir., 1968); *Zanesville Inv. Co. v. Commissioner,* 335 F. 2d 507 (6th Cir. 1964)) the better view permits the disallowance of deductions for post-acquisition losses of an acquired corporation where those deductions were a part of the purpose for which the corporation was acquired. *Luke v. Commissioner,* 351 F. 2d 568 (7th Cir. 1965); *R. P. Collins & Co. v. United States,* 303 F. 2d

142 (1st Cir. 1962). See also *J. T. Slocomb Co. v. Commissioner,* 334 F. 2d 269 (2d Cir. 1964).

Thus it appears that the majority below was of the view that their decision was in conflict with the decisions of the Third and Sixth Circuits in *Herculite* and *Zanesville*, but that it agreed with those of the First and Seventh Circuits in *Collins* and *Luke* v. *United States,* 351 F. 2d 568 (C.A. 7). We submit, however, that there is not such a conflict as may appropriately be resolved by a grant of certiorari in the instant case.

*Zanesville* involved two corporations, one that was losing money and one that was profitable. The common sole stockholder transferred the stock of the losing company to the other so that the former's losses could be set off against the profits of the second company on a consolidated return. The Commissioner sought to invoke Section 269 to block the setoff. In holding the setoff consistent with Section 269, the Sixth Circuit viewed the stockholder as having sought to offset the losses of one of his businesses against the profits of another. The court stressed that the "test" is whether the "legislative plan [is] violated by allowing the deduction in question," and principally relied on the fact that such an offset was consistent with a general legislative plan to allow (335 F. 2d at 510) "[i]ndividuals, partnerships, and corporations * * * to offset the losses incurred in one business of the taxpayer against profits realized in another business of the same taxpayer." The court suggested that there were several ways in which the offset could have been secured without threat of disallowance under Section

269. For example, the corporations could have elected to be taxed under Subchapter S of the Code and thereby be taxed as partnerships, or the corporations could in fact have been dissolved into proprietorships (see 335 F. 2d at 512). Thus the situation was seen as not fitting within (*id.* at 513) "the principal purpose of Section 269", *i.e.*, a denial of tax benefits "which could be obtained only by acquiring * * * a corporation which, because of its own history, had obtained such benefits and which benefits the acquiring person could not otherwise have obtained."

However, the court of appeals in *Zanesville* included a caveat in its opinion (*id.* at 514):

> It is noteworthy that the cases construing Section 269 to date have all involved situations where the loss sought to be utilized flowed from the corporation's individual past history *or from the fact that the corporate rather than some other form of business organization was involved and was otherwise unobtainable under any other provisions of the Code.* But, as we have seen, that is not the case here, as Muskingum's losses could have been realized and offset against other income if the several businesses had been conducted in non-corporate forms or if Muskingum's assets had been dissolved into the taxpayer. [Emphasis supplied.]

The italicized language fits the instant case exactly. By using the corporate form, Borge and petitioner avoided the application of Section 270 that would otherwise have been inevitable. It was only through the use of the corporate form that Section 270 could be avoided. And the quoted language demonstrates

that the Sixth Circuit viewed a situation such as this as materially different from the facts that confronted it in *Zanesville*.

Thus the Sixth Circuit's opinion does not go so far as petitioner suggests, *i.e.*, it does not hold that Section 269 may never be invoked to disallow losses that are economically sustained after the acquisition in question. Rather *Zanesville* does no more than implement the statutory language which limits the application of Section 269 to the disallowance of tax benefits "which such person or corporation would not otherwise enjoy." The Sixth Circuit was apparently of the view that the availability of other means of offsetting the business losses and gains of the same taxpayer meant that the tax benefit in question there *could* have been "otherwise" enjoyed. Nothing comparable may be said of this case. Rather, the "legislative plan" envinced in Section 270 would be thwarted if Section 269 did not bar deductions that could not have been enjoyed without the incorporation of Borge's poultry business.

*Herculite* involved a different set of facts. One Hyman acquired all the stock of the Herculite Company after it had sustained substantial losses for several years. Those losses continued after the acquisition and Hyman later merged the company with another corporate enterprise of which he was also the sole shareholder and which was profitable. The merged company claimed a carryover deduction for the losses Herculite had sustained both before and after the acquisition. The Commissioner sought to bar the entire deduction under Section 269.

The Third Circuit sustained the disallowance of the deduction of losses incurred before Hyman's acquisition of the Herculite stock but held that Section 269 could not bar the deduction of losses incurred thereafter. The Third Circuit viewed the government's position as being that the post-acquisition losses should be disallowed merely because of the "taint" of an improper attempt to obtain a deduction of preacquisition losses. The court said (387 F. 2d at 476):

> Certainly such post-acquisition losses would have been deductible by way of carry-over had not pre-acquisition losses also been claimed. Zanesville Investment Co. v. Commissioner of Internal Revenue, 6th Cir., 1964, 335 F.2d 507. *Thus, their deduction is in no sense artificial and represents no unjust enrichment of the taxpayer.* Indeed, in this case Hyman appears to have advanced money to the corporation to help finance the 1960 post-acquisition operations with resultant losses about equaling the advances. [Emphasis supplied.]

Thus the Third Circuit rested its decision on the fact that the post-acquisition losses standing by themselves could have been offset against the post-acquisition earnings of the merged enterprise. On the other hand, Borge's use of the corporate form to avoid the application of Section 270 in his personal tax situation presents both the artificiality and the "unjust enrichment of the taxpayer" that was found lacking in *Herculite*.[4]

In summary, it is an attempt to overcome the application of Section 270 which creates the essential dis-

[4] *Herculite* does conflict with *R. P. Collins & Co.* v. *United States*, 303 F. 2d 142 (C.A. 1).

tinction between the instant case on the one hand and *Herculite* and *Zanesville* on the other. Both the Third and Sixth Circuits have indicated that they would view the present case as presenting a materially different situation than *Herculite* or *Zanesville* respectively.

To be sure, the majority of the Second Circuit indicated here that it is in disagreement with the Third and Sixth Circuits. The majority opinion here may well mean that the Second Circuit, given the same facts as existed in *Zanesville* or *Herculite,* would rule in favor of the government rather than the taxpayer. In appropriate circumstances, we would urge that the opinion here should be so construed.

But the record of this case presents only the narrower question whether Section 269 may be invoked when a proprietorship is incorporated in order to avoid the application of Section 270. Since the cases are clearly distinguishable on their facts, we submit that the present case does not present an appropriate vehicle for resolving a conflict of decisions among the courts of appeals.

## CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted.

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MAY 1969.

# APPENDIX

For taxable years ending before January 1, 1964, Section 269(a) of the Internal Revenue Code provided:*

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX

(a) In general.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means

* Section 235(c)(2) of Public Law 88-272, 78 Stat. 19, 126, amended Section 269(a) by substituting "then the Secretary or his delegate may disallow such deduction, credit, or other allowance" for "such deduction, credit, or other allowance shall not be allowed". The amendment applies to taxable years ending after December 31, 1963.

the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

* * * * *

[26 U.S.C. 269(a).]

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